78-321

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1978

ROBERT MEYER, JANE MEYER, CHARLES PARKER, MARILYN PARKER,

Appellants,

v.

THE UNITED STATES OF AMERICA

Appellee.

PETITION FOR WRIT OF CERTIORARI

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~~On Appeal from the Court of Claims of the United States~~

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THE OPINION BELOW

The Decision of the United States Court of Claims is reported as Document No. 79-72 and appears herein as Appendix A. No other written opinions have been delivered.

STATEMENT OF THE GROUNDS ON WHICH THE JURISDICTION OF THIS COURT IS INVOKED

(i) This case came before the court on plaintiffs' exceptions to the recommended decision of Trial Judge Lloyd Fletcher, filed December 30, 1976, pursuant to Rule 134(h), having been submitted on briefs and oral argument of counsel. The Court of Claims on February 22, 1978 affirmed and adopted the opinion of the Trial Judge as the basis for its judgment in the case. Plaintiffs' subsequently filed a motion and petition on April 14, 1978, pursuant to Rule 151 of said Court, for retrial and rehearing with reference to the opinion entered on February 22, 1978, which dismissed plaintiffs' petition. Upon consideration of same said motion for retrial and rehearing was by the Court of Claims denied on May 26, 1978. Said motion suspended the finality of the judgment of February 22, 1978 until the Court of Claims denial of the motion on May 26, 1978, which had the effect of restoring it, and the running of the time for appeal. Communist Party of Indiana v Whitcomb, 414 US 441, 445.

Appellants contend that the Opinion of the court below was in error both as to the application of the Sixteenth Amendment of the United States Constitution, and that the court below has made serious and substantial errors in the application of the federal tax law under said amendment.

(ii) The judgment or decree to be reviewed is the ruling of the United States Court of Claims denying appellants' motion for retrial and rehearing as requested under Rule 151 of said Court.

(iii) Jurisdiction of the appeal is conferred on this Court by Title 28 of the United States Code, Section 1255.

(iv) Cases sustaining the jurisdiction of this Court are:

Uterhart v United States, 240 US 598
Freuler v Helvering, 291 US 35
Blair v CIR, 300 US 5
Sharp v CIR, 303 US 624
Lyeth v Hoey, 305 US 188.

(v) The application of Section 102(a) of the Internal Revenue Code of 1954 is here involved, as it applies under the Sixteenth Amendment of the United States Constitution. The full text of said section is as follows:

Section 102 (a) General rule — Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. 26 USC 102(a).

In the application of this section it is the appellants' contention that said court either ignored or misapplied the rule fully set forth by the United States Supreme Court in Lyeth v Hoey, 305 US 188, on identically the same set of facts as presented in that case, with one exception seemingly peculiar to the case presented by this appeal: that is, that there was a lapse of time between the death of the ancestor of twenty years and the probate of the estate of the ancestor in this case that was not presented in the case of Lyeth v Hoey, supra. But it should be noted that the mere lapse of time may represent income realization to the estate, not to the heir-claimants. A transfer of *appreciated* property in satisfaction of a legacy was considered a sale or other disposition on which the *estate realized income* in Suisman v Eaton, 15 Fed Supp 113, affirmed in 83 Fed 2d 1019.

See also Kenan v CIR, 114 Fed 2d 217, 219, Diebold v CIR, 194 Fed 2d 266, Williamson v CIR, 100 Fed 2d 735, Commercial National Bank of Charlotte v United States, 196 Fed. 2d 182. If it is income realized by the estate of the ancestor it cannot be income to the heir-claimants. It also has been frequently reiterated in tax law that the law does not stop at the form of a transaction, it goes to its substance. Thus, income received is taxable or *nontaxable* according to what it represents. Hort v CIR, 313 US 28. Whatever the appellants here received they received it as heirs of their ancestor, Bertha Segerstrom, for only as heirs did they have any standing, as was noted in Lyeth v Hoey, supra. As heirs they acquired what they acquired by inheritance in the same sense as an acquisition by bequest was considered in United States v Merriam, 263 US 179, in the sense that no actual service was required as a condition in the payment of said inheritance. Cotnam v CIR, 263 Fed 2d 119. Any appreciation as above considered refers to appreciation in the hands of the estate of the decedent, not while in the possession of the decedent himself, and realization of the income is to the estate, not the distributee, which could be, as appellants suggest,could be an heir, as in this proceeding, in the same context as considered in United States v Gavin, 159 Fed 2d 613, or a legatee in United States v Merriam, supra. As the Gavin case noted where a party claimed a share of an estate as a pretermitted heir, money she received in settlement of her claim was not taxable as income to her in the nature of valuable consideration for the surrender of the claim against an estate in the ordinary sense on the ground that the transaction represents a dealing in property, the gain from which is taxable income, citing Lyeth v Hoey, supra, in support of such proposition. Appellants further contend, as will be shown in Questions Presented by this Appeal that a substantial federal question is involved when a decision of a federal court, and one immediately below that of the United States Supreme Court in the hierarchy of the federal judicial system, transcends the limits imposed by the Sixteenth Amendment of the United States Constitution by not declaring the law as it is, but as the court deems it to be. Kelly v Aarons, 238 Fed 996. In this respect the Secretary of the Treasury and the Court of Claims cannot justify regulations set forth by the secretary and his designated

representative, the Commissioner of Internal Revenue, that alter or amend the revenue law. All such branches of government can do is to regulate the mode of proceedings to carry into effect what Congress has enacted into law. Morrill v Jones, 106 US 466, 467; Waite v Macy, 246 US 606, 609, 610. The judgment and opinion of the court below has affected this result contrary to the holding of these cases.

QUESTIONS PRESENTED BY THIS APPEAL

The following questions are presented by this appeal:

1. Does the decision of the Court of Claims, in affirming the decision of the Internal Revenue Service, to impose an income tax upon the appellants, violate the Sixteenth Amendment of the United States Constitution, where such proceeds passed to appellants as the result of a settlement of their claim to the estste of an ancestor who died in 1944, but which settlement, arising out of a case pending in the Superior Court of the State of California for the County of Orange, Case No. 19909, was not made until 1965, arising out of a claim filed by the appellants through a cross complaint filed in 1964 in said action?

3. Is the settlement in which appellants entered into exempt from income taxes under Section 102 (a) of Title 26 of the United States Code, as contemplated by Congress when it enacted that section to the code?

4. Was there a sale of a capital asset, as held by the court below in the absence of a finding of the value of the capital asset which was sold; or whether or not there was a sale of a capital asset at all by the appellants herein; and whether such sale, if there was a sale, met the test as to fair market value frequently invoked by the United States Supreme Court in cases dealing with the subject of capital assets and gains? If there was a sale was the subject of the sale not a realization of income to the estate of appellants' ancestor, not the appellants, as considered in Suisman v Eaton, 15 Fed Supp 113, and Kenan v CIR, 114 Fed 2d 217, 219?

5. In conjunction with issue 4 above, was there income derived by the appellants to which income tax consequences could attach arising out of a settlement of an uncertain and disputed claim in and to the estate of appellants' ancestor,

Bertha Segerstrom; or was the estate of the ancestor the recipient of any appreciation or income, while the taxable impact wrongfully fell upon the heirs, if there was income at all arising from the transaction to which this matter relates?

STATEMENT OF THE FACTS OF THE CASE

The taxpayers in this matter which filed for refund of taxes paid the Internal Revenue Service are Robert I. Meyer and Marilyn E. Meyer, brother and sister, and they seek a refund of such taxes and interest thereon which they paid for the calendar year 1965. Their respective spouses were also plaintiffs in this action by reason of joint income taxes filed for that year. In 1965, Marilyn and Robert had each received $175,000 in cash as a settlement of a California Superior Court lawsuit. That suit, brought by them (as cross-complainants in said action) against various members of their family (the Segerstroms), asserted that Robert and Marilyn had been improperly excluded from sharing in the estate of their grandmother, Bertha Segerstrom. They demanded a judgment declaring them owners of certain property interests allegedly held by their grandmother on the grounds that she died intestate in 1944, and that they were, among others, her heirs at law, and, in addition, an award of certain compensatory and punitive damages for lost enjoyment and fraudulent concealment. The Agreement of Settlement is hereby attached as Appendix B to reflect that the settlement was not for an award of compensatory and punitive damages for lost enjoyment and fraudulent concealment, which was an Exhibit in these proceedings before the Court of Claims; but was in settlement of any claim that might be later found valid to the Estate of Bertha Segerstrom, appellants' ancestor, who died in 1944, if such estate was found to exist. The adversary parties in the 1965 proceedings, including the son of Bertha Segerstrom, one Harold Segerstrom, who was duly issued Letters of Administration as the Administrator of her estate at all times denied that Bertha Segerstrom had any estate, and in accordance with that denial petitioned the court for a termination of the Probate Proceedings, herein marked Appendix C, and was issued a Decree by the Superior Court of the State of California for the County of Orange, holding therein that no estate was found to exist in the name of Bertha

Segerstrom. The Internal Revenue Service, as the result of the 1965 settlement, determined that the settlement transaction resulted in the sale or exchange of a capital asset, namely, the taxpayers' "claim" against Bertha Segerstrom's Estate, and, as will be noted below, in consequence, prejudged the ultimate outcome of the 1965 litigation had it gone to final judgment as being adverse to the finding that there was an estate, when the 1965 judgment still leaves open this very point under both federal and state law. Freuler v Helvering, 291 US 35, Berniker v Berniker, 30 Cal 2d 439, 447, Lamb v Lamb, 171 Cal 577, England v Winslow 196 Cal 260, 277, Leviston v Tonningren, 212 Cal 656, 664, 665, Cohn v Cohn, 7 Cal 2d 1, 8, Dillon v Cross, 5 Cal App 766, 769. The Internal Revenue Service by such determination held that a substantial amount of capital gain, attributable to the appreciation of the claim over the some twenty years it remained unasserted was thereby realized, and that this gain amounted to 75 percent of the settlement proceeds.

The taxpayers and appellants herein, disaggreed entirely with the Service's analysis of the tax consequences of the settlement. After paying tax deficiencies of $16,772.23 plus interest of $3,585.60, and $17,445.57 plus interest of $3,729.53, respectively, Marilyn and Robert filed timely claims for refund, which the Service formally disallowed. They then timely filed their petition in the Court of Claims for a refund of the amounts so paid, citing Lyeth v Hoey, 305 US 188 (1938) as the authority that such settlement proceeds did not constitute taxable income as to the entire settlement proceeds as being a "taxfree inheritance" within the meaning of Section 102 (a) of the Internal Revenue Code of 1954.

THE FEDERAL QUESTIONS PRESENTED ARE SUBSTANTIAL

Section 61 of Title 26 of the United States Code states in very broad terms the items that are included in gross income. The section, in its first sentence, ncludes in gross income "all income from whatever source derived" that is not elsewhere specifically excluded. The language used is taken from the Sixteenth Amendment and is intended to include in gross income all items that are constitutionally income and that are not excluded by

the provisions of some other section of the code. Thus, the first substantial federal question raised is whether the holding of the court below exceeds the definition as to what is income imposed by the Sixteenth Amendment of the United States Constitution.

Since the Court of Claims made an allocation, or affirmed same made by the Internal Revenue Service, between taxable and non-taxable income, on the premise that Lyeth v Hoey, 305 US 188 permits such under the factual situation raised in this case, appellants believe that this raises a substantial federal question of significant impact on the orderly administration of the federal tax law. It is of major and material importance to orderly tax administration that there be consistency, uniformity, and predictability in its implementation. With the adherence of the court below the Secretary of the Treasury, through his representatives, have taken the step of adopting a fallacious "in lieu of what" theory or test, over that of the test imposed by the United States Supreme Court in Lyeth v Hoey, supra. For the premise adopted by the Court of Claims and the Treasury Department to have validity the federal law would have to hold that the appellants acquired a vested right, as a matter of state law as of the date of death of the ancestor, Bertha Segerstrom, in 1944. Revenue Code Section 102 (a) *exempts from taxable income* all the "value of property *acquired* by gift, bequest, devise or inheritance. If *acquired* as set forth in the code means as of the date of death by the ancestor, under the facts of this case, the year 1944, the Court of Claims holding would be unquestioned. The estate of Bertha Segerstrom would stand fixed in value as of 1944, the date of her death. Considerable tax law has been propounded by the United States Supreme Court, and various inferior federal courts, holding to the contrary. This is not merely in the interest of consistency and uniformity, but more importantly, is to avoid the consideration of an estate of a decedent, in this case, the Estate of Bertha Segerstrom, as a taxable entity, liable for *all* estate taxes on said estate for the estate that existed prior to and since 1944, and up to the time of distribution of said estate, which is, as of 1978, yet to occur. Suisman v Eaton, supra, Commercial National Bank of Charlotte v United States, 196 Fed 2d 182. Is the estate not subject to all such tax consequences until such taxes have been paid? Is the finding of the Superior Court of the State of

California that Bertha Segerstrom had no estate, as reflected in its 1965 decree, binding upon the United States Government, which was not a party to such proceeding, or is it bound by determinations there made? Such estate is still subject to full and complete determination of estate tax liability under both state and federal law, (see citations above) particularly in the light of the fact that Harold segerstrom, one of the adversaries in the 1965 litigation, took it upon himself to assume the duties of administrator for the Estate of Bertha Segerstrom, and has never renounced his fiduciary relationship to that estate, he may personally be liable, or his estate, for any and all failures to fully perform those fiduciary duties, and diligently determine the status of Bertha Segerstrom's estate, which appellants in this matter respectfully suggest to the Court he not only negligently, but intentionally failed to do. CIR v Bosch, 87 Sp Ct 1776 As the court in Lyeth v Hoey, supra, noted, Congress has *not* indicated any intention to tax again *a value* of the property which legatees, devisees or heirs *receive from* the decedent's estate. To the degree appellants received anything by the 1965 settlement they received it as heirs of Bertha Segerstrom, as the United States of America, the respondent, has conceded as being appellants' status, if disputing what they received. Only as heirs could they have received anything under the facts of this record, and whatever they received had to be through the Estate of Bertha Segerstrom. Lyeth v Hoey, supra, simply established the test that when their is a settlement between such heirs and other claimants in the estate of their ancestor (whether they be legatees, devisees or other heirs) what is received by way of settlement must be deemed to have the same status or character of what would have been received had the litigants pursued the matter to ultimate judgment. In the 1965 litigation had the appellants pursued the matter to ultimate judgment, and received the identical same amount that they received in the settlement, they would have received such from the estate of Bertha Segerstrom, as a part of said estate as it existed in 1965, or the time of said judgment in such litigation, though such part may have exceeded the total of the gross estate as it existed in 1944. If they had, in fact, by such ultimate judgment, received property in kind acquired by Bertha Segerstrom or her estate, either before or after her death in 1944, the basis of such

property acquired or received would then have been subject to capital gain consideration on the eventual sale, if ever it should be made, of all or any part of such property received in kind by the appellants, had such been the case. The significance of this proposition is that what appellants' received in the settlement—all of what was received by them—was within the exception of Section 102 (a) of the 1954 Internal Revenue Code. Appellants here stand in no different legal position than the appellant Hoey did in Lyeth v Hoey, supra. As the court said there — petitioner obtained that portion, upon the value of which he sought to be exempt from income tax because of his standing as an heir and of *his claim* in that capacity. It does *not* seem to be questioned that if the *contest* had been fought to a finish and petitioner *had succeeded,* the property which he would have received would have been exempt under the federal act. The court, in this proceeding, is apparently attempting to distinguish this case from Lyeth on the grounds of the lapse of the 20 years between the death of the ancestor, Bertha Segerstrom, and the settlement in 1965. But in 1965 *if* the appellants here had pursued the action to final judgment, what ever they would have acquired would be by and through the estate of Bertha Segerstrom, as her heirs, and *what* they would have acquired they would have acquired by inheritance within the meaning of the act.

The Court in Lyeth also noted that the distinction sought to be made between acquisition through a judgment and acquisition by a compromise agreement in lieu of such judgment is too formal to be sound. No mention is made for purposes of Section 102(a), or the predecessor section having similar or identical language under the 1939 code that Hoey acquired *a vested* interest at the death of the ancestor measured to the date of judgment. What an heir acquires on the death of an ancestor is a chose in action to his proportionate share, whatever that may be under state law, to the estate of his or her ancestor, subject to the claims of creditors and all proper payments of both state and federal taxes due and owing by the ancestor, and/or the estate of the ancestor. The court below imposed an entirely fallacious test inconsistent with the holding of Lyeth v Hoey, supra, that the appellants received what they received for the sale (by them) of their "claim" in the Estate of Bertha Segerstrom. If this is the test than Lyeth v Hoey, supra,

and the test applied there, has been superceded and is no longer the rule of law in United States tax law. Appellants firmly believe that the test of Lyeth v Hoey is still the law and that the ruling of the court below applying an inconsistent test requires resolution of this question and raises a major and substantial federal question that only can be answered by the United States Supreme Court, if a new test or a supercission of the rule of Lyeth v Hoey has in fact occurred, either by Congressional act or by case law. Appellants respectfully but firmly dispute that such a new test applied to settlement cases involving heirs and their ancestors has come to be part of such law.

In addition to changing the test invoked by Lyeth v Hoey, such a new test would raise fundamental questions on what constitutes income as to a particular taxpayer, in light of the many cases in which the definition of income for income tax purposes has been considered by this Court. If the Lyeth test is still applicable, and appellants believe that it is, and that their case can not be distinguished from that of Lyeth but for the lapse of time, then the amount received in the settlement is not income to the appellants within the meaning of the Sixteenth Amendment of the United States Constitution. If the new test, so-called, invoked by the Court of Claims, has any validity, it would be apparent that there could be two recipients of the same income—both liable for a tax—the Estate of Bertha Segerstrom and the appellants themselves. The Sixteenth Amendment presupposes that there is only a given amount of income at any given time allocated to and payable by a particular taxpayer—the party who, in most cases, earned that income, Bertha Segerstrom could not have earned income after her death in 1944, but her estate could, and did, even though it may be in the hands of a resulting trust or constructive trustee, if she had an estate, which appellants in the earlier state proceedings asserted that she did at the time of the settlement which is the subject of this litigation, and appellants, by reason of said settlement, are barred from pursuing the validity of this contention after the date of the settlement. United States v Gavin, supra. Only the appellants, not the United States of America or any other interested party, including other heirs, are barred from continuing to make such assertion. Note cases cited above, including Freuler v Helvering, 291 US 35. A right if any to a

judgment, being a mere chose in action is not a capital asset from which any capital gains can be measured. Champlin v CIR, 71 fed 2d 23, 30.

To deem something income to a particular taxpayer it must be derived from either a contribution of capital or from a contribution of labor by the party that is to be taxed, according to the test frequently laid down by this Court. Eisner v Macomber, 252 US 189. It is conceded by the Government in this action that appellants contributed no labor to the supposed income derived from the settlement. It is further conceded that the appellants had standing as "heirs" within the meaning of Lyeth v Hoey, supra, as the Government acknowledged that such doctrine as that case contributed to federal tax law applied in part to the settlement proceeds which passed to appellants. Thus, if there is income within the meaning of the Sixteenth Amendment of the United States Constitution to the appellants it must have been derived from appellants' contributions of capital. The Court of Claims held the contribution was the vested right appellants acquired in the ancestor's estate in 1944. If this proposition is correct then how could the estate have a realization at any time after the death of a decedent in the context considered in Suisman v Eaton, supra, and Kenan v CIR, supra? *Only* as appellants acquired a vested right in 1944 is there a basis for showing a capital contribution to the later appreciation that apparently resulted to the Estate of Bertha Segerstrom. In the sense that an ancestor who makes a will and thereby becomes a testator, and through such will provides for a specific legacy or devise to a named legatee or devisee, who incidentally may also be an heir at law of said ancestor, does the heir at law acquire a vested right in a particular property, upon the disposition of which to said heir by the estate, *and a later sale* by the heir will a gain or income be realized. An heir has a vested right only in the estate of an ancestor in the generic sense—having a right to the corpus of the estate generally, not as to any particular asset within said estate as would a specific legatee or devisee. As noted above appellants in these proceedings had a chose in action, one which was disputed and uncertain in the state proceedings, Segerstrom v Meyer, Case No. 126316, and thus, only a chose in action to what ever rights they may be entitled to in the estate (and the corpus, if any) of the decedent,

Bertha Segerstrom, by reason of her death in 1944, at which time their status as heirs became absolute, not inchoate, while their rights to some share of the estate depended upon the existence of an estate, the corpus of the estate, whatever that might be, and what was eventually available for distribution to heirs as heirs, since it is conceded by all parties that Bertha Segerstrom died intestate. Appellants frequently emphasized and reiterated in the trial of this matter before the Court of Claims that it was never ascertained what Bertha Segerstrom's estate might be in the 1965 litigation because the adversaries in that proceeding first denied that she ever had any estate, and since they were also heirs to the same estate, one of which was Harold Segerstrom, as son, stood in per capita not per stirpes, and was, under California law, entitled to act as administrator of said estate, thus, stood in an effective position to assert the denial of the existence of any estate in Bertha Segerstrom, either until ultimate judgment of that matter, or until the settlement relieved him, as to appellants, of any obligation of administering said estate. As to all other parties, including the United States, Harold Segerstrom was still liable and under an affirmative duty as administrator to faithfully discharge his duties to said estate, which appellants, again, suggest, he failed to do. Harold Segerstrom is now deceased, having passed away early in 1978 while living in the City of Santa Ana, State of California. His estate, under both federal and state law, stands in his shoes, and continues to remain liable in the same manner as Harold Segerstrom would be for any breach of any fiduciary duty for failure to properly administer said estate. According to the Court of Claims the right or contribution of capital, from which a taxable gain was derived by appellants, was a sale of the "claim" they had in the Estate of Bertha Segerstrom. If it had been proven that Bertha Segerstrom had no estate in a proper and adversary proceeding and appellants had received, in spite of such proof, the proceeds of the settlement here then the test invoked by the Court of Claims would be conceded by appellants to be a valid test, for they would have received something for which they were not in any manner legally entitled. Even then, it might be arguable that such settlement was a gift or donation on the part of the other parties in an adversary proceeding since under such circumstance they would

have had no legal duty to make payment of such a settlement award, but did so only as a means of shortening the time of litigation as to such matter, through all stages of appeal and to the point where the doctrine of res judicata would be applicable, and thereby, still not be income, but a donation or gift. Early v CIR, 445 Fed 2d 166, Elrick v CIR, 485 Fed 2d 1049. The appellants' claim was, and still is, a *disputed* and *uncertain* claim in the Estate of Bertha Segerstrom, barred now from assertion by reason of the 1965 settlement agreement, herein attached, marked Appendix B. It may hypothetically be conceded, in aid of a clear exposition of the points raised, that had the "claim" resulted in a judgment in favor of appellants then such right would be vested in them in the Estate of Bertha Segerstrom. Had it become, under such circumstances, a vested right, the vesting would be conceded by appellants to relate back to 1944, but only for the purpose of establishing the capital basis of any assets which appellants *might* have received "in kind" from the ancestor's estate, which they did not under the facts presented by this record. Without such capital contribution any so-called appreciation in the Estate of Bertha Segerstrom, which still remains an uncertainty as to its existence or of any corpus therein in 1978, though there may be such, there can be *no income,* taxable or otherwise, within the meaning of the Sixteenth Amendment of the United States Constitution.

To hold otherwise, and adopt the fallacious test applied by the Court of Claims—that appellants' acquired a vested interest in 1944—is also to deny the estate as a taxable entity. The appellants were noted as holders of at least, had they received any judgment on their "claim," to be a one ninth interest in a specific parcel of real estate, the so-called Home Ranch, by which judgment, had there been a judgment, they may have received in kind, but in such event such one ninth interest, as tenants in common, would have passed to them at the time of judgment through the estate of Bertha Segerstrom, and distribution to appellants of such interest would not have been a taxable event until they chose to sell such one ninth interest, if ever; and at most a one ninth interest in a one fifth interest in an oral partnership which controlled all of the property held by the Segerstrom family, see Appendix E as to a description of said

property; and as the depositions in the state action disclosed in 1965, this included the Home Ranch which was mortgaged by Bertha Segerstrom alone during her life time for the benefit of the family farming partnership. See Appendix F showing the Mortgages executed by Bertha Segerstrom. The partnership was admittedly oral, not in writing, as noted in the deposition of Harold Segerstrom in the 1965 proceedings. See Appendix G. Such deposition brought out that the proceeds or income from all parcels went into a family pot or bank account, and from said pot or bank account all new additional properties were purchased, all mortgages on all parcels, including the Home Ranch, were paid, and all property and income taxes were accounted for over a period of many years from said account— but that until 1965 and the litigation in the state court such family pot or bank account was never made a part of the disposition of any estate of any of the partners of said family partnership, whether they were conceded to be partners of the oral partnership or not. See Appendix K and L as to actions taken by surviving partners against a surviving partner, and the disposition of his estate, noting under Appendix K that it was a claim filed by one of the partners against the partner then deceased for terminal illness expenses, which was allowed by another of the partners while acting as executor of the estate of the deceased partner, though the claimant himself was a coexecutor of the deceased partner, being Harold Segerstrom, the same person who was later administrator of the estate of appellants' ancestor, Bertha Segerstrom; yet said deceased partner supposedly died seised of $1,673,865.72 worth of real estate in his own name, without, apparently, having had any apparent means of acquiring such vast wealth. Since the Court of Claims, in its opinion, made a significant point that there was never a Winding Up of the Partnership at the death of the ancestor of appellants, Bertha Segerstrom, it can only be pointed out that there was never a winding up of the partnership affairs upon the death of any of the partners until the death of Anton Segerstrom in 1964, and the litigation from which these proceedings arose in 1965, for such properties were all held, other than in the bank account in the names of individual members of the family rather than in the partnership. See Appendixes I and L. Had the claim of the appellants to the

partnership interest of Bertha Segerstrom been proven and established in the 1965 litigation the appellants would have been entitled to no particular assets or corpus, as under California law such partnership assets pass to the surviving partners subject to settlement of the interest of the deceased partner. Corporation Code 15018, et. seq., Probate Code Sections 421 and 422. Such settlement could be in cash or other property, depending upon the terms and circumstances of the settlement, which then through the estate of the deceased partner would pass to his heirs or devisees subject to any taxable gains if the estate sold said corpus and distributed the proceeds of sale, or subject to a capital basis in the hands of the heirs or devisees of the deceased partners as it had been in the hands of the ancestor under Section 1014, Title 26, United States Code. Only such settlements as are made in kind by the surviving partners to the estate of the deceased partner could be the source of capital later found in the possession of the heirs at law of the deceased partner. By the 1965 settlement was the appellants received was a settlement in money (not money's worth) in this matter. As the court noted in Lyeth v Hoey, supra, the petitioner there, and the appellants here, assert the same proposition, that said petitioner had the status of an heir, and what he got *from the estate* came to him because he was an heir—not because of any capital contribution by the appellants.

As to the so-called "in lieu of what" theory raised by the Government and accepted by the Court of Claims in these proceedings the appellant respectfully reiterates that such a test is fallacious and a distortion of the application of the doctrine laid down by this court in Lyeth v Hoey, supra. Appellants, at the time of the 1965 litigation in settlement thereof, and prior to that date, had no vested interest or right of any kind in any property of Bertha Segerstrom, corporeal or incorporeal, as at no time, to the present, has there been established Bertha Segerstrom had any estate upon which such vested interests could be founded. It may well be that the contentions of the adversaries in the 1965 litigation were correct and there was no estate in Bertha Segerstrom, but this would have no relevance or bearing as to the applicability of the federal tax test applied in Lyeth v Hoey. This is not to say that no estate does not, or did not, exist, as it may yet be proven that such an estate does exist,

to which appellants might still have a claim, but for the 1965 settlement agreement. If such were the case today, any distribution to appellants would be a distribution *of and from the estate* the value of which is not taxable as income under Section 102 (a) of the 1954 Internal Revenue Code. In this context the test in Lyeth v Hoey was conceived by the Supreme Court in 1938 and is as valid law in 1978 as it was at that time. That is, when there is a settlement it is tested by whatever a party's ultimate rights would have been, and what they would have received *if* successful in an ultimate judgment. Had appellants here been successful in obtaining a judgment in the 1965 litigation, what they received they would have received as heirs of Bertha Segerstrom, for the purposes of federal tax consequences. The proceeds which they, in fact, received is tested by this very test, for only as heirs did appellants here have any standing in the 1965 litigation. Lyeth v Hoey, supra. If there was in fact a partnership interest in Bertha Segerstrom, it having been conceded by the adversaries in the state action that there was an oral partnership, that the bringing of an action by an administrator of the estate of a deceased partner against a surviving partner for accounting, and the delay in bringing such action, is a matter of which the representative of the deceased partner alone, under California law, could complain, and not a third party against whom surviving partners brought action. Rosenberg v J. C. Penney Co., 30 Cal App 2d 609. The problem raised in these proceedings is that the administrator of the Estate of Bertha Segerstrom, Case No. A-48194, in the Superior Court of the State of California, for the County of Orange, was Harold Segerstrom, an adversary in the 1965 proceedings, Case No. 126318, in the same superior court, of which the settlement in this matter arose. Only as appellants could have acted under Probate Code 421 of the State of California to designate a new administrator would there have been a possible independent and objective determination of the status of the Estate of Bertha Segerstrom.

The distribution as the result of any judgment in a state court proceedings, by the fact of distribution alone, would not have been taxable as income, and such distribution from the estate of money would not, under any circumstances constitute a sale or exchange for income or capital gain purposes. Early v CIR, supra, Elrick v CIR, supra. The attorneys fees incurred by the heirs are also deemed to be part of the net estate of the ancestor, and not income to the distributees, as noted in Commercial National Bank of Charlotte v United States, 196 Fed 2d 182, and this also reinforces the conclusion made or asserted by appellants that the proceeds of a settlement is not income to them. See also Suisman v Eaton, supra.

The settlement in 1965, combined with the decree filed in 1965, leaving for future determination the issue of the existence and value of the Estate of Bertha Segerstrom does *not* bind the federal government, as it was not a party to said action, and the statute of limitations as not run on the government under either federal or state law, but has become res judicata as to the appellants in these proceedings. Gallagher v Smith 223 Fed 2d 218, at page 223, while discussing the various types of state decisions, and their effect on federal tax law, noted "This is because the right to the income or other property sought to be taxed is created solely by state law." Since by hypothesis no federal qualification or criterion has been imposed and the tax is levied *solely* upon those in whom the state law has *vested the title,* the question can only be one of state law. An adjudication of such a question of title by a court must accordingly be given effect, not because it is res judicata, but because it is conclusive of the parties' property rights which alone are to be taxed. If the state court's judgment has binding final effect under the state law the rights of the parties can only be what the court has held them to be. It is for this reason that the *federal court should not* in a case of this kind make an independent examination and application of state law. For if it reaches a different conclusion from the state court as to what the parties' rights should be under the state law its decision will not change those rights which will necessarily remain what the state court has declared them to be. The Government and the Court of Claims has not, in this matter, or any other proceedings, to the knowledge of the appellants, contested the Superior Court of the State of California for the County of Orange did not have jurisdiction, or that the settlement entered into by appellants and the plaintiffs in the 1965 litigation were in any way ineffective or invalid as to affect the rights of the appellants. In Gallagher v Smith, supra, it cites in support of the above proposition

Uterhart v United States, 240 US 598, Freuler v Helvering, 291 US 35, Blair v CIR, 300 US 5, and Lyeth v Hoey, 305 US 188.

For capital gain consequences to arise there must be first a capital asset. Second, there must be a vested interest by the taxpayer in that asset. Third, there must be a sale of the asset for a consideration in money or money's worth which gives rise to a capital gain. For a capital gain to be established both the courts and the Treasury Regulations require that a fair market value be established as to the asset from which the gain is derived. Fitts Estate v CIR, 237 Fed 2d 729. Treasury Regulations 10581.10. O'Malley v Ames, 197 Fed 2d 256. Fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller, *neither* being under any compulsion to buy or sell. The Government in this proceedings have contended, all along, that there has been a sale. But a sale to whom? If any sale of a capital asset did occur here was it between a willing buyer and a willing seller, neither under any compulsion to buy or sell? Who besides the adversaries in the 1965 proceedings would have bought any interest of Bertha Segerstrom from the Plantiffs in this matter? Until final litigation appellants had only an *uncertain and disputed claim* that there was any estate at all in Bertha Segerstrom, which was firmly and repeatedly denied by the adversaries as existing, and clearly asserted by the administrator of her estate, who was one of those adversaries, as reflected in the Decree of Discharge and Termination of Estate. See Appendix C. There was no buyer or seller, willing or otherwise, in the 1965 litigation, for there was no sale in the sense required under federal income tax law. Early v CIR, 445 Fed 2d 166, Elrick v CIR, 485 Fed 2d 1049. Again, this is not to say that had the adversaries in the 1965 proceedings given consideration, in the sense allowed by US v Gavin, supra, that was not in the form of money, but property in kind, it would have become vested in the appellants after the execution of the Settlement Agreement and any later sale of said asset by appellants would give rise to capital gain considerations under Section 1014 of Title 26 of the United States Code; and without establishing the purchase price of such assets subsequent to 1944 by the constructive trustees in 1965 the appellants would have been bound by a finding that such an asset had a value as of 1944, the date of death of Bertha Segerstrom, the gain from

which would be recognized as having capital gain consequences in 1965. But there was out of these proceedings no settlement in kind, only the payment of money, in the sense considered in Early v CIR, supra, and Elrick v CIR, supra. See also CIR v National Alfalfa Dehydrating and Milling Co., 472 Fed 2d 796 as to a receipt in kind. While federal estate tax consequences as to the estate of Bertha Segerstrom still remain moot appellants note that it is conceded that federal estate tax liability, where a property interest, or lack of it has been determined by a state court, *does not* bind the federal government as to such determination, for estate tax purposes. CIR v Bosch, 87 Sp Ct 1776.

If, in fact, the $350,000 had been derived from a sale of a capital asset in 1965, of which at best the plaintiffs would have had a one ninth interest, per stirpes, and at the least, one forty fifth interest, per stirpes, had they been ultimately successful in asserting their right to an interest in the Estate of Bertha Segerstrom, the appellants would, under the contention of the Government in this proceeding and the opinion of the Trial Judge of the Court of Claims incurred a double taxation as it would be the sale of a capital asset, known to the Government, a sale by the constructive trustees to raise the $350,000 from other third party purchasers, which would have been subject to a capital gain treatment in the hands of the constructive trustees, either short or long term, depending upon the acquisition date of the so-called "asset," either by Bertha Segerstrom or her estate, and under the presumption of the law that all government officers have properly performed the function that they have been assigned the Internal Revenue Service would have collected the capital gain taxes due from such sale. If the sale alleged to have taken place by these proceedings did occur as the Government has contended, it was to the Segerstrom family itself and the proceeds of such sale were paid with funds which belonged to the appellants in part, in the first place, if they acquired a vested right in such estate in 144; thus, the appellants were losing title supposedly over an asset deemed to be their property, at least in part, for money which is also deemed to be their property, at least in part. It is, by analogy, as if a thief stole the appellants' property back in 1944, made a considerable income or appreciation off of said property that

they had wrongfully stolen in the first place, and then with said income or appreciation purchased title to the very property stolen from the legal owner with the profits which belonged, in the first place, to the legal owner, not to the thief.

To the extent that a distribution to an heir, or a bequest under a will to a legatee, is not deductible to the estate it is deemed part of the estate for tax purposes, and is not income to the heir or distributee. United States v Merriam, 263 US 179. Where a legally potential heir or actual beneficiary under a will engages in litigation to establish his rights to a portion of the estate, his attorneys fees are *not* deductible *to the estate,* Reg. 20.2053-3(c)(3), and such payments are charged to the estate, and deemed a part of it. Being income of the estate it is the estate that should be taxable under the Sixteenth Amendment of the United States Constitution for such income. Commercial National Bank of Charlotte v United States, 196 Fed. 2d 182. This is assuming that the proceeds of a settlement, such as in the last cited case, were from profits derived by the estate after the death of the decedent, and part of such net estate. As to appellants in this proceeding, whatever passed to them, passed under the test applied in Lyeth v Hoey, supra, not the so-called test applied by the Court of Claims, and this relates to all the proceeds for which the appellants in this matter settled for and received, not a part, as contended by the Government, since whatever was received by appellants, under such test, had to pass through the Estate of Bertha Segerstrom for the appellants to have received anything, for the Estate of Bertha Segerstrom, for purposes of said test, had to consist of whatever existed by right, title and interest in her at the time of her death in 1944, and any appreciation accruing to said estate since 1944, and up to the time of the 1965 settlement, in the context considered in Gallagher v Smith, 223 Fed 2d 218, and Lyeth v Hoey, supra. The Internal Revenue Code notes that if an estate collects income, or enjoys appreciation, from property owned or held by it, and such assets are not actually distributed to the heirs, the income is income to the estate and not taxable to the heirs or legatees. Internal Revenue Code, Title 26 United States Code, Section 691(a)(4). The estate must pay the income tax thereon. Section 691(a)(1)(A).

Appellants herein have respectfully submitted that the

proposition set forth in Lyeth v Hoey, 305 US 188, and related cases, is the correct and sound proposition of federal income tax law, and not the supposed test applied by the Court of Claims in the opinion set forth by that court in these proceedings. The application of the test set forth in Lyeth v Hoey does not avoid the possibility of capital gain treatment under the proper circumstances, and facts, not presented in this case. Even though there is appreciation in value in the hands of the estate, assuming Bertha Segerstrom had an estate to which appreciation did in fact arise, there was, and is, no taxable event in the transfer to an heir in the settlement of an estate under such circumstances. Suisman v Eaton, 15 Fed Supp 113, Diebold v CIR, 194 Fed 2d 266. In Williamson v CIR, 100 Fed 2d 735, the taxpayer argued that an exchange had occurred in the same context that the Government contends in these proceedings, but consistent with Lyeth v Hoey the court found that the heir had received the corpus—not the income. In Early v CIR, 445 Fed 2d 166, and Elrick v CIR, 485 Fed 2d 1049, these cases, in support of the test and rule laid down in Lyeth v Hoey, held the proposition that an uncertain and disputed claim released by the so-called taxpayer in exchange for money (not property in kind) is not a capital gain from the sale of a capital asset. For the same reason as considered in the Williamson case the courts, in effect, found that the heirs or devisees had received the corpus, not the income.

The conclusion, appellants respectfully contend, is that the judgment of the Court of Claims below is invalid if for no other reason that it is contrary to the Sixteenth Amendment to the United States Constitution in holding that settlement proceeds, in part, are as to the appellants, income, for neither labor or capital of the appellants was present to produce any income within the meaning of that amendment; that the test applied by the Court of Claims erroneously, as a matter of law, departs from the test validly laid down in Lyeth v Hoey, 305 US 188, as to such settlements; that the settlement in which appellants entered into is exempted from income tax consequences as to appellants under Section 102 (a) of Title 26 of the United States Code, as contemplated by the United States Congress when it enacted that code section; that there was not a sale or exchange of a capital asset, both under the context considered in Early v

CIR, supra, and Elrick v CIR, supra, and for reason of the absence of a willing buyer and a willing seller, neither under any compulsion to buy or sell, and for the additional reason it remains a moot question to the present time as to whether there was any estate upon which a sale or exchange could be founded having a fair market value upon which such appreciation, if any could be measured, and within the contest of Suisman v Eaton, 15 Fed Supp 113, Diebold v CIR, 194 Fed 2d 266, Williamson v CIR, 100 Fed 2d 735, the appreciation, if any, was the income of the estate, to which the Government should look for any income tax consequences that may arise therefrom.

Respectfully Submitted

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EXHIBIT A

In the United States Court of Claims

No. 79-72

(Decided February 22, 1978)

CHARLES E. PARKER, MARILYN E. PARKER, ROBERT I. MEYER AND JANE M. MEYER v. THE UNITED STATES

Charles E. Parker, pro se, for plaintiffs.

David C. Hickman, with whom was *Assistant Attorney General M. Carr Ferguson,* for defendant. *Theodore D. Peyser,* of counsel.

Before COWEN, *Senior Judge,* NICHOLS and BENNETT, *Judges.*

OPINION

PER CURIAM: This case comes before the court on plaintiffs' exceptions to the recommended decision of Trial Judge Lloyd Fletcher, filed December 30, 1976, pursuant to Rule 134(h), having been submitted on the briefs and oral argument of counsel. Upon consideration thereof, since the court agrees with the trial judge's recommended decision, as hereinafter set forth*, it hereby affirms and adopts the

* Whereas the court adopts the trial judge's separate findings of fact, which are set forth in his report filed December 30, 1976, they are not printed herein since such facts as are necessary to the decision are contained in his opinion.

same as the basis for its judgment in this case. It is, therefore, concluded that plaintiffs are not entitled to recover and their petition is dismissed.

OPINION OF TRIAL JUDGE

FLETCHER, *Trial Judge:* The taxpayers in this suit for refund of Federal income taxes are Robert I. Meyer and Marilyn E. Parker, brother and sister, and they seek a refund of such taxes and interest thereon which they paid for the calendar year 1965.[1] In 1965, Marilyn and Robert had each received $175,000 in cash as a settlement of a California Superior Court lawsuit. That suit, brought by them against various members of their family (the Segerstroms), asserted that Robert and Marilyn had been improperly excluded from sharing in the estate of their grandmother, Bertha Segerstrom. They demanded a judgment declaring them owners of certain property interests allegedly held by their grandmother, as well as an award of certain compensatory and punitive damages for lost enjoyment and fraudulent concealment. The Internal Revenue Service determined that the settlement transaction resulted in the sale or exchange of a capital asset, namely, the taxpayers' "claim" against Bertha's estate, that a substantial amount of capital gain, attributable to the appreciation of the claim over the some twenty years it remained unasserted was thereby realized, and that this gain amounted to 75 percent of the settlement proceeds.

The taxpayers disagreed entirely with the Service's analysis of the tax consequences of the settlement. After paying tax deficiencies of $16,772.23 plus interest of $3,585.60 and $17,445.57 plus interest of $3,729.53, respectively, Marilyn and Robert filed timely claims for refund, which the Service formally disallowed. They then timely filed their petition in this court for a refund of the amounts so paid. They say that under the doctrine of *Lyeth* v. *Hoey*, 305 U.S. 188 (1938), they are clearly entitled to exclude

[1] The spouses of these taxpayers are also plaintiffs in this action, but apparently so only because joint income tax returns were filed by each couple for the year in question.

from taxable income the entire settlement proceeds as being a taxfree "inheritance" within the meaning of Section 102(a) of the Internal Revenue Code of 1954, reading:

> (a) General rule. —Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. 26 U.S.C. § 102(a).

The Government continues to take essentially the same position as the Service conferee had done in his analysis of the settlement transaction and has treated the receipt of the settlement proceeds as gain realized on the sale or exchange of a capital asset. While the Government's argument has considerable merit and an appealing simplicity, it seems to me subject to some criticism in that it tends to gloss over the Supreme Court's general approach to § 102(a) in *Lyeth* v. *Hoey*, *supra*, particularly as elaborated in later decisions by the lower Federal courts. As will be shown, one result of this has been a faulty allocation of the settlement proceeds. However, to the extent there was error, it was committed in favor of the taxpayers, and they have failed completely to show any overpayment of their 1965 Federal income taxes. Accordingly, under the landmark decision of *Lewis* v. *Reynolds*, 284 U.S. 281 (1932), they are not entitled to recover the refunds claimed for that year. See, also, *Dysart* v. *United States*, 169 Ct. Cl. 276, 340 F.2d 624 (1965).

The facts of the case are somewhat complicated by the large size of the Segerstrom family of which taxpayers are a part.[2]

C. J. Segerstrom was a farmer engaged mostly in the cultivation of lima beans. He and his wife, Bertha, had eleven children, one of whom (Esther) was the mother of plaintiffs, Robert Meyer and Marilyn Parker. Some years prior to his death in 1928, C. J. had formed a partnership

[2] Counsel for the parties were successful in agreeing upon a partial stipulation of facts. In addition, a trial was conducted before Trial Judge Charlotte Murphy in Los Angeles, California, on March 24 and 25, 1975. The findings based upon these proceedings are detailed in the Findings of Fact which are summarized here only to the extent necessary to understand the reasons for the conclusions reached in this opinion.

with four of his sons as equal partners. They continued the operation of the farming business under the partnership name of C. J. Segerstrom & Sons, and over the years the enterprise expanded considerably. By 1944, it was farming about 2,000 acres, all of which was then agricultural land in Orange County, California. Owing, however, to an influx of defense related industries and accompanying population growth, the character and value of the partnership property experienced a rather spectacular change. Much of the acreage was being serviced by new freeways, and industrial parks and shopping malls began to develop. By the time of the commencement of the litigation referred to above the value of the Segerstrom properties was estimated to be somewhere close to $60,000,000.

Bertha Segerstrom died in January 1944 survived by eight of her children and by Robert and Marilyn, children of her deceased daughter, Esther. Bertha apparently died intestate,[3] and the record discloses no formal administration of her estate although much later there was an inheritance tax proceeding conducted in the Orange County Superior Court. Partnership income tax returns for the family partnership of C. J. Segerstrom & Sons were filed for years following C. J.'s death in which returns Bertha was shown as holding a one-fifth interest therein. However, Bertha's partnership status does not appear to have been otherwise recognized by her sons except possibly for tax purposes, and it is unclear on this record whether she was, in fact, a member of the family partnership. More clear is the fact that there was never a formal dissolution or winding up of the partnership affairs at her death.

Indeed, as previously stated, in the usual sense, there was no formal administration of Bertha's estate at all.[4] However, in 1951, there was a Superior Court proceeding for the determination of state inheritance taxes on certain real property received by Bertha's surviving children shortly after her death. According to the state tax

[3] In 1951 an inheritance tax appraiser referred to her as having died "testate," but the record here indicates this to have been in error.

[4] It does appear that more than 20 years after Bertha's death, her son, Harold, did file a petition for letters of administration on her estate.

assessor's report in that proceeding, this property was transferred pursuant to a "gift deed" executed in 1930 but recorded in 1944 after Bertha's death. By this deed, the surviving eight of Bertha's eleven children appear to have received a joint tenancy with right of survivorship in a property known as the "Home Ranch," a 110-acre farm operated by the family partnership and owned by Bertha. Marilyn and Robert were not mentioned in such deed and were not involved in the 1951 inheritance tax proceeding in any way, nor were they shown as entitled to any share of Bertha's putative partnership interest or any other asset of Bertha. In fact, although it was reasonably clear that they were two of Bertha's numerous heirs-at-law, no effort was made to inform them of the inheritance tax proceeding or of any other matter involving Bertha's estate.[5]

In the 1951 inheritance tax proceeding referred to above, six of Bertha's children filed their petition in the Orange County Superior Court representing that no administration had been had upon Bertha's estate but that in 1930 she had executed a certain deed of gift conveying certain real estate (the Home Ranch) to her then living children as joint tenants with right of survivorship. The petition further represented that the grantees named in the deed comprised all of Bertha's heirs-at-law and that one of them, Ida Segerstrom, had predeceased Bertha. No other property interest of Bertha was mentioned but the petitioners believed that the transfer of the Home Ranch was subject to California inheritance tax which they desired to be determined.

Whereupon the court appointed an inheritance tax appraiser and directed him to report the amount of tax due, if any, on such transfer. In due course, the appraiser reported to the court that the fair market value of the property at the date of Bertha's death was $122,000. After deducting therefrom the funeral expenses, unpaid taxes,

[5] From the record herein, it is not clear why older members of the Segerstrom family tended to ignore the interests of these two grandchildren of Bertha. It may well be that, as laymen, they simply failed to appreciate the heirship status of both Robert and Marilyn who were very young children when their mother died and who thereafter lived and grew up with families other than the Segerstroms.

attorneys' fees, court costs, unpaid balances of trust deeds, and Federal tax, he arrived at a "clear market value" for the property of $78,183. Bertha's eight surviving sons and daughters thereupon paid their aliquot share of the resulting inheritance tax totaling $763.68.

As stated, Marilyn and Robert, Bertha's other heirs, were completely unaware of the inheritance tax proceeding. However, in 1963, Marilyn's husband, Charles E. Parker, who was a title attorney for the First American Title Company, happened to examine the probate file for the estate of Ida Segerstrom, a daughter of Bertha who predeceased her. Reference was made in this file to Bertha's estate and to the 1930 deed of gift in which Ida was an original donee. Charles was intrigued by what appeared to him to be inconsistencies in these records. He and Marilyn then consulted her brother, Robert. While he knew nothing about the matter, he was, of course, interested.

Charles continued his investigation and consulted with his colleagues at the title company. Marilyn and he also made inquiries of members of the Segerstrom family.

The result of all this was the commencement of litigation. In July 1964, Harold T. Segerstrom, et al. filed a Complaint to Quiet Title, naming Robert, Marilyn, and unknowns as defendants.

Marilyn and Robert counterclaimed in the quiet title suit and joined many other relatives as parties defendant to the cross-complaint. This cross-complaint, as later amended, alleged not only that Marilyn and Robert were entitled to a share of the Home Ranch, but also that they were entitled to a share of Bertha's partnership interest, that they were entitled to lost income since 1944, and that the cross-defendants had defrauded them and engaged in a continuing conspiracy of concealment to deprive them of their rightful interest. The taxpayers demanded $10 million dollars in punitive damages for the torts. They also demanded a declaration of ownership in the property withheld from them, *i.e.*, the lands and the partnership interest, plus $5 million dollars for lost income.

The entire suit, including the cross-complaint, proceeded to the pretrial stage, and extensive depositions were taken in preparation for trial. However, the suit was settled. The settlement was accomplished partly because one of the older Segerstroms who had been scheduled for deposition was in frail health, partly because a *lis pendens* which taxpayers had filed against all partnership property, even though previously removed, was nevertheless hampering significant business negotiations, partly because there had been uncovered another gift deed to the Home Ranch (this one executed and predating the 1930 gift deed but not filed until 1965), and partly because the suit was splitting the family apart as well as affecting its intricate development negotiations. Marilyn and Robert each received $175,000 as their one-half share of the total settlement, and it is the taxability of this receipt which is presently in issue here.

In a perceptive analysis written before the Supreme Court's decision in *Lyeth* v. *Hoey*, *supra*, a distinguished tax commentator aptly described the nature of receipts flowing from a compromise agreement entered into to avoid a will, or other post-mortem, contest as "irritatingly elusive of definition." Paul, "Tax Status of Will Contestants," Selected Studies in Federal Taxation (2d Series) pp. 305, 328 (1938). The Supreme Court endeavored to correct the existing confusion by its decision in the *Lyeth* case.

There the taxpayer, Lyeth, was a grandson and heir under Massachusetts law of Mary Longyear, who left him and her other heirs small legacies but gave the residue of her estate of over $3,000,000 in trust to preserve "the records of the earthly life of Mary Baker Eddy," the founder of the Christian Science religion. Lyeth and the other heirs opposed probate of the will on grounds of lack of capacity and undue influence. Before the case came to trial, a compromise agreement was entered into by all parties, approved by the Court and incorporated in its decree admitting the will to probate as modified by the agreement. Lyeth's distributable share of the residue under the compromise was valued at over $140,000, all of which the Commissioner treated as ordinary income in the year of receipt. The case came up on action for refund of over

$56,000 in taxes paid on this award, the Second Circuit siding with the Commissioner in 96 F. 2d 141, and the Supreme Court granting certiorari on the resulting conflict with the Fourth Circuit in *Magruder* v. *Segebade*, 94 F. 2d 177, (4th Cir. 1938).

The Court first discarded the argument that under state law the payment would be deemed to have been made by purchase (i.e., a contract bargain) rather than by inheritance. The Court recognized that state law determines who are the heirs, the validity of the will, and the procedure for probate and compromise. But once the taxpayer is so determined to be an heir and has so received payment under valid compromise, whether what he has received has been "acquired by gift, bequest, devise or inheritance" under the Code section quoted above is then properly a federal question in order to give uniformity to the application of the Code.[6]

The Court then ruled that, in passing the Code exemption above, Congress used comprehensive terms embracing all acquisitions in the devolution of a decedent's estate. This was such an acquisition because of Lyeth's status as an heir-at-law. The Court elaborated the point at p. 196:

> There is no question that petitioner obtained that portion, upon the value of which he is sought to be taxed, because of his standing as an heir and of his claim in that capacity. It does not seem to be questioned that if the contest had been fought to a finish and petitioner had succeeded, the property which he would have received would have been exempt under the federal act. Nor is it questioned that if in any appropriate proceeding, instituted by him as heir, he had recovered judgment for a part of the estate, that part would have been acquired by inheritance within the meaning of the act. We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound, as it disregards the substance of the statutory exemption. It does so, because it disregards the heirship which underlay the compromise, the status

[6] This general proposition is, of course, well settled. See, *Burnet* v. *Harmel*, 287 U.S. 103 (1932) and the discussion in Michaelson, "Tax Effects of Estate Contests," 16 N.Y.U. Tax Inst. 1021 (1958).

> which commanded that agreement and was recognized by it.

The rule thus established by *Lyeth* seems but a specialized application of the familiar concept that, in determining the tax characteristics attributable to amounts received under a court judgment, the crucial question to be resolved is "In lieu of what were the damages awarded?" *Raytheon Production Corp.* v. *Commissioner*, 144 F. 2d 110, 113 (1st Cir. 1944), *cert. den.* 323 U.S. 779 (1944). *Lyeth* established that the question is equally important in determining the true nature of proceeds received in settlement of estate litigation.

Thus, it is clear that the ultimate question to be resolved in the present case must be this. In lieu of what did Marilyn and Robert receive $350,000 in settlement of their cross-complaint against the other members of the Segerstrom family. From the discussion below, it will become apparent that the answer to this deceptively simple question is far from easy.

The Government's approach to the "in-lieu-of-what" test is objectionably narrow. It would restrict the *Lyeth* v. *Hoey* doctrine to a situation where the settlement proceeds constitute a portion of the same assets which the caveator-heir would have received either by direct inheritance or by prevailing in his lawsuit to recover such inheritance. It is true that on its particular facts, *Lyeth* did involve a settlement under which the proceeds received by the heir were for the most part an in-kind distribution. However, this circumstance does not prevent application of the *Lyeth* principle to a cash settlement in lieu of an in-kind distribution. See, for example, *United States* v. *Gavin*, 159 F. 2d 613 (9th Cir. 1947) where in the settlement of a will contest, the claiming heiress received a substantial sum of money from the other heirs in lieu of her claimed percentage interest in the decedent's real estate. The Government made much the same arguments there as here, but the Tenth Circuit Court of Appeals rejected them as contrary to *Lyeth* v. *Hoey* and held that the cash settlement proceeds were property acquired by "inherit-

ance" so as to be exempt from income tax.[7] See, also, Schenck, "Tax Effects of Will Contests and Compromises," 1961 Tul. Tax Inst. (10th Annual) 214, and Fouts, "Payments Received in Settlement of Litigation and Claims," 25 N.Y.U. Tax Inst. 555 (1967).

The Government, however, relies heavily on *White* v. *Thomas*, 116 F. 2d 147 (5th Cir. 1941) in support of its position that the *Lyeth* principle has no application here. In the *White* case, the taxpayer had filed suit against an estate claiming that, during their lifetimes, the decedent and her husband had given him a 124,000-acre ranch. He bore no family relationship whatever to the decedents but was their good friend and house companion. The dispute was settled by a compromise agreement whereby the executors paid the taxpayer $125,000 in exchange for his release of all claims against the estate. He asserted that the entire amount was exempt from income tax under *Lyeth*, but the Fifth Circuit disagreed, stating:

> . . . When what is received by a compromise is a part of the very thing claimed, the assertion is correct. If White, claiming all the ranch as a gift, had been conceded part of it, the land he thus got would stand as a gift. But in this case he got no land, but money. Yet he never claimed the Shannons had given him any money. The executors and trustees had no authority to give him anything, and did not intend to. They paid him money for the release of the right which he claimed in the land. White sold that right, and conveyed it by suffering the adverse judgments. He converted it into cash; and the gain from the conversion of a gift is taxable, though the receipt of the gift originally was not. He did not sell the land itself, for he had neither title nor possession. He could not deduct the cost of the land to the Shannons, for they never parted with it and no proof of their cost was made. He sold only his claim to recover it, which was in the nature of an incumbrance on the title, at a price which was only a fraction of the value of the land; and that claim he does not say cost him anything. What he received is income. 116 F. 2d 147–8.

[7] The Government's failure to mention the very apposite *Gavin* case in its brief here probably is indicative of a complete disagreement with the case.

Despite the rather sweeping language just quoted, the *White* case is simply not in point here because of its significantly different facts. Unlike the present case, the taxpayer there was not an heir in any way so there could be no possible claim of entitlement to anything by way of "inheritance." Clearly, there was no "devise" of the land to him, and his claim that he was the donee of an oral *inter vivos* "gift" thereof equally clearly could not convey a valid title to real estate and was therefore ineffectual at best. Small wonder, then, that the court could "perceive no sustainable view whereby the money received would not be taxable as income." 116 F.2d 148.

From what has been said, it is concluded that the principles established by *Lyeth* v. *Hoey* have at least some application to the facts of the present case. This is not the end of the matter, of course, since it does not follow that *Lyeth* automatically exempts from tax the entire amount received by plaintiffs under the compromise agreement. There remains for consideration the impact, if any, of the "in-lieu-of-what" rule referred to above, and this necessarily requires an analysis of what claims were compromised by the settlement agreement.

Under his contention that the entire transaction should be viewed as a sale by Marilyn and Robert of their claim against Bertha's estate, it was necessary for the I.R.S. conferee to construct a 1944 basis for the claim from which gain or loss could be computed. This proved to be extraordinarily difficult not only because of the lapse of time and the failure to administer Bertha's estate,[8] but also because of the large number of real estate parcels involved coupled with the fact that a number of changes in the Orange County Tax Assessor's records over the years had

[8] A simple approach, of course, would have been to accept the determination of the California inheritance tax appraiser that Bertha's entire estate was comprised only of the Home Ranch and was worth only $122,000. Computing taxpayers' basis as one-ninth of that amount would result in a total basis of only $13,555. Despite its simplicity, such an approach would have been manifestly unfair, for it ignores the myriad other serious claims made by Marilyn and Robert in their cross-complaint. Indeed, the I.R.S. conferee seems to have recognized the unfairness of any such approach.

rendered it virtually impossible to trace all Segerstrom parcels back to 1944.

During the course of negotiations, it was finally determined, with the assistance of a private tax research firm selected by taxpayers' then counsel, with the conferee's approval, that five parcels of land should be traced from 1944 to 1965. After comparing the value of these parcels of land and after additional negotiations, the conferee decided that, with respect to real estate in the vicinity of land allegedly owned wholly or partially by Bertha Segerstrom, approximately 25 percent of the land's 1965 value represented its value in 1944 and 75 percent represented appreciation in value between 1944 and 1965. Applying these percentages to the amounts received by Marilyn and Robert in settlement of the litigation, the Service finally determined that taxpayers' claim had a total value in 1944 of $90,404. Adding to this basis the $80,000 in attorney's fees incurred by taxpayers, a total basis of $170,404 was established, leaving the balance of $179,596 as a taxable long-term capital gain.

From the foregoing it is obvious that the Government views the settlement proceeds of $350,000 received by Marilyn and Robert as totally allocable to that portion of their cross-complaint which demanded a declaration of part ownership in the various Segerstrom real properties. In my opinion, however, such an allocation is erroneous since it ignores the other causes of action alleged in the cross-complaint which undoubtedly played a significant role in bringing about the eventual settlement.

It is clear that the Service conferee erred in failing to consider all causes of action alleged by Marilyn and Robert in their cross-complaint to which some portion of the settlement proceeds could have been allocated. The rule has been well stated by the Eighth Circuit Court of Appeals in *Carter's Estate* v. *Commissioner*, 298 F. 2d 192 (8th Cir. 1962) where the court said at p. 194:

> It is well-settled law that the classification for tax purposes of amounts received in settlement of litigation is to be determined by the nature and basis of action settled. [Citing cases.] If it is found that such a settlement is one in respect to a claim for lost profits or partly for lost profits and partly in lieu of punitive damages such as are recoverable in anti-trust litigation, there can be no question as to their taxability as ordinary income. [Citing cases.]

See, also, Rev. Rul. 58-418, 1958-2 C.B. 18 holding that amounts received in lieu of an award for punitive damages are taxable to the recipient as ordinary income. On the other hand, of course, under *Lyeth* and *Gavin, supra,* amounts received in lieu of corpus of an estate will be exempt from income tax. *Cf. Harte* v. *United States*, 252 F.2d 259 (2d Cir. 1958).

Because of uncertainties as to the assets comprising Bertha's estate, if any, because the state court never entered a judgment in the present case, and because the settlement agreement itself made no specific allocation of the proceeds, the court unfortunately is deprived of the usual guidelines for determining a reasonable allocation. *Cf. Tree* v. *United States*, 102 Ct. Cl. 128 (1944), *cert. den.* 324 U.S. 852 (1945) where this court closely examined the terms of a more precise settlement agreement in applying the "in-lieu-of-what" test.

In the Fourth Cause of Action set forth in their cross-complaint, as amended, Marilyn and Robert alleged fraud and concealment on the part of their uncles, who were the surviving partners in the family partnership, and accordingly, they prayed for "punitive damages" in the sum of $10,000,000. However, in the ensuing settlement agreement, Marilyn and Robert agreed that all such allegations of fraud, misrepresentation and concealment were untrue and without merit. In view of this concession, it would seem highly unrealistic to allocate any portion of the settlement proceeds to the tort demands for punitive damages, and they are, therefore, eliminated from consideration.

Elimination of those issues leaves for analysis the other causes of action asserted in the cross-complaint. Essentially they are reducible to demands for (1) a one-fifth ownership interest in the Home Ranch, (2) a one-forty-fifth ownership

interest[9] in any real estate held by the family partnership, and (3) compensatory damages for loss of what the cross-complaint calls "the use, enjoyment, rents, issues, and profits" attributable to the complainant's interest in Bertha's estate and alleged to aggregate $5,000,000. Demand was made for an accounting of all of the partnership property and the profits therefrom since Bertha's death.

In determining a reasonable allocation of the settlement proceeds among these several causes of action, where the agreement itself does not do so, resort to the pleadings is proper and may be helpful. See, for example, *Raytheon Production Corp.* v. *Commissioner, supra; State Fish Corp.*, 48 T.C. 465, clarified at 49 T.C. 13 (1967); *Telefilm, Inc.*, 21 T.C. 688 (1954), reversed on another point 55–1 USTC ¶ 9453 (9th Cir. 1955); and Rev. Rul. 58–418, *supra. Cf. Tree* v. *United States, supra.* In the present case, the pleadings placed a monetary value only on the cause of action for lost profits, while the remaining demands sought only a declaration of part ownership in realty. However, at the trial of this tax dispute, evidence was produced which for allocation purposes sufficiently fixes the value of the Home Ranch and the partnership realty as of 1944, the year of Bertha's death.

For California inheritance tax purposes, the Home Ranch was estimated to be worth $122,000. The 2,000 acres of partnership realty were estimated to be worth no more than $1,000 per acre, or $2,000,000 for the entire 2,000 acres. Thus, if Marilyn and Robert had inherited their alleged shares of Bertha's estate in 1944, by intestate succession, they would have collectively received a one-ninth interest in the Home Ranch plus a 1/45 interest in the partnership, and at 1944 valuations, this would amount to a $13,555 interest in the Home Ranch and a $44,444 interest in the partnership realty. The $5,000,000 demanded for lost income from the partnership operations between 1944 and 1965 represents a 1965 evaluation, however, and cannot be simply added to the 1944 values

[9] The fraction of 1/45 was calculated as one-ninth of Bertha's one-fifth interest in the partnership.

without gravely distorting the base figure for allocation. The 1944 values should be adjusted and projected to 1965 by using the realty appreciation factor developed during the several conferences with I.R.S. conferees. This factor showed a mean growth of about 500 percent for all Segerstrom properties.

Thus, in terms of 1965 values, the taxpayers sought in the cross-complaint a $67,775 (500 percent of $13,555) interest in the Home Ranch, a $222,220 (500 percent of $44,444) interest in the partnership realty, and a $5,000,000 judgment for lost income. Hence, approximately $290,000 in real property interests and $5,000,000 in lost income were sought.

There are two choices for allocating at this point. First, the $350,000 settlement can be prorated according to the ratios that the real property interests and the income interest bear to the total amounts demanded; i.e., 290,000/5,290,000 (or 5.5 percent) of the settlement for land interests and 5,000,000/5,290,000 (or 94.5 percent) for the lost income. This method allocates almost all of the settlement to income and is unrealistic because it mixes plaintiffs' likely inflated and fictional demands for allegedly lost income with the actual real property values. The second and, under the circumstances here, more reasonable choice is to subtract the adjusted land values from the total settlement proceeds and treat the remainder as compensation for allegedly lost income. By this calculation, $290,000 of the settlement proceeds would have been received in lieu of the ownership interests asserted in the real property, and the remainder of $60,000 would be attributable to the claimed compensatory damages for lost income.

Under such an allocation, taxpayers obviously would be liable for tax at ordinary income rates on the full $60,000, since that portion of the settlement was received in lieu of ordinary income and is therefore not excluded from income by Section 102, even as extended by *Lyeth.* See, *Harte* v. *United States, supra,* and *Raytheon Production Corp.* v. *Commissioner, supra.*

As to the proceeds received in lieu of the fractional ownership claims to realty, Section 102, as interpreted in

Lyeth, allows that portion received by reason of heirship and thus akin to "inheritance" to be excluded from taxable income. Since the values of plaintiffs' 1944 inheritance, as computed above, were $13,555 for the Home Ranch and $44,444 for the partnership interest in realty, these amounts are excludible from gross income under Section 102.

However, the remaining $232,000 received in lieu of the claims to fractional ownership of real estate has not been shown by the taxpayers to be anything other than taxable income, after an adjustment, discussed below, for attorney's fees. It was, of course, open to them to show that this remainder was some sort of capital item such as unrecovered basis, or somehow otherwise not subject to income tax. They were unable to do so, however. All the evidence submitted can lead to no other conclusion but that this remaining amount was received in lieu of the rather spectacular appreciation of the properties over the 21-year period between the date of death and the date of settlement.[10]

The Government says that this realized appreciation was taxable as long-term capital gain. While for reasons previously stated, the Government's allocation procedure was faulty, I agree with its basic contention that the settlement here constituted a taxable event to be measured, *inter alia*, by the appreciation over the years.

[10] In tacit recognition of the fact that income was generated by this entire transaction, taxpayers suggest that, if so, such income was not taxable to them but either to Bertha's estate or to the cross-defendants. The theory seems to be that whatever the amount taxpayers received by the settlement, it was only their "inheritance" and therefore subject to the Section 102 exclusion from gross income without reference to the source of the proceeds. The difficulty with this argument is that in other cases where the taxpayer, as here, has received more in settlement than he would have received under a will or through intestacy, he must prove that the excess was something other than income from the property which is the subject of the inheritance claim. See, for example, *E. C. Delmar*, 25 T.C. 1015 (1956). The argument also fails to take into account that if such excess is income upon which income tax should have been paid, the recipient heir may well be liable for such tax under the transferee provisions of Section 6901 of the Code. In the circumstances of this case, however, it is unnecessary to reach that question, particularly since the Segerstroms agreed in the settlement agreement to hold harmless Marilyn and Robert for any possible transferee liability.

Accordingly, taxpayers are liable for long-term capital gains tax on $168,560, as computed in the schedule below.

Finally, there remains for consideration the I.R.S. allowance of taxpayers' attorney fees as an adjustment to the basis of their "claim". Section 1016(a) of the Code allows as an adjustment "expenditures . . . properly chargeable to capital account . ." Here the attorney's fees, insofar as they were expended in the acquisition of property, are available for adjustments to basis. See, *Woodward* v. *Commissioner*, 397 U.S. 572 (1970), and *Elrick* v. *Commissioner*, 485 F.2d 1049 (App. D.C., 1973). Also, Section 212 allows as a deduction "all ordinary and necessary expenses paid or incurred . . . for the production or collection of income."

Here Marilyn and Robert expended $80,000 in attorney's fees to secure the settlement proceeds. As shown above, of the settlement proceeds, $60,000 was for lost income from the alleged partnership interest. A pro rata amount of the attorney's fees attributable to recovery of such income, or approximately $16,560, is therefore deductible under Section 212. Treas. Reg. § 1.212-1(k) (1965). The remainder of the attorney's fees, $63,440, is allowable as an adjustment to basis under Section 1016, since it was expended in the acquisition of money attributable to the real estate ownership interests (which, as previously discussed, included the attendant appreciation). *Cf.* Rev. Rul. 58–418, *supra* (amount of settlement not includible in income reduces proportionately the amount of attorney's fees deductible under Section 212).

In summary, the taxpayers have been required by the Service to include in gross income $179,596[11] on which they paid income taxes at long-term capital gain rates. However, the record here shows that as a result of the settlement the taxpayers should have reported net income of $212,000 of which $43,440 (in lieu of lost income) was taxable as ordinary income and $168,560 was taxable as long-term capital gain.[12]

[11] $350,000 settlement proceeds less $170,404 comprised of $90,404 basis and $80,000 attorney's fees.

[12] To arrive at the amount reportable by each taxpayer, of course, these figures

The following schedule shows the results of the foregoing allocation in tabular form:

Total Amount Received Under Settlement		$350,000
Less Adjusted Basis:		
Amount received as "inheritance"	$58,000	
Portion of attorney's fees attributed to basis	63,440	
Less amount attributed to lost income and taxable as ordinary income	60,000	181,440
Amount taxable as long-term capital gain		$168,560
Amount Taxable as Ordinary Income	60,000	
Less portion of attorney's fees attributed to lost income	16,560	43,440
Total of taxable settlement proceeds after above adjustments		$212,000

From this table it is at once apparent that far from showing an overpayment of their 1965 income taxes, the taxpayers have actually underpaid their taxes for that year.[13] Nearly 45 years ago, the United States Supreme Court in its decision in *Lewis* v. *Reynolds*, 284 U.S. 281, 283 (1932) instructed us that in tax refund cases:

> . . . An overpayment must appear before refund is authorized. Although the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded.

Accordingly, plaintiffs are not entitled to the refunds claimed, and their petition must be dismissed.

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would simply be divided by two.

[13] Apparently satisfied with the amount of taxes previously collected, however, the Government has not counterclaimed for any additional tax.

CONCLUSION OF LAW

Upon the trial judge's findings and the foregoing opinion, which are adopted by the court, the court concludes as a matter of law that plaintiffs are not entitled to recover, and their petition is dismissed.

IN THE UNITED STATES COURT OF CLAIMS

No. 79-72

CHARLES E. PARKER, MARILYN E. PARKER,
ROBERT I. MEYER AND JANE M. MEYER

v.

THE UNITED STATES

Before NICHOLS, Judge, Presiding, COWEN, Senior Judge, and BENNETT, Judge.

ORDER

This case comes before the court on plaintiffs' motion and petition, filed April 14, 1978, pursuant to Rule 151, for retrial and rehearing with reference to the opinion entered herein on February 22, 1978, which dismissed plaintiffs' petition. Upon consideration thereof, without oral argument,

IT IS ORDERED that plaintiffs' said motion for retrial and rehearing, filed April 14, 1978, be and the same is denied.

BY THE COURT

MAY 26 1978

Philip Nichols, J.

Philip Nichols, Jr.
Judge, Presiding